Internal Revenue Service

memorandum

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FS:IT&A:JCAlbro

date: DEC 30 1991

to: District Counsel, Ft. Lauderdale CC:MIA
Attention: William B. McCarthy

from: Assistant Chief Counsel (Field Service) CC:FS

subject: [redacted], / [redacted]
Advance Ticket Deposits

This is in response to your request for field service advice dated October 28, 1991, which is a follow-up to our views provided to you in our memorandum dated May 24, 1991.

ISSUES

1. Whether [redacted] should be allowed an offset for the related expenses of airline tickets, the cabin space, and the travel agent's commission?

2. Presuming that the answer to question 1 is that [redacted] should be allowed offsetting expenses, whether determining those expenses by reference to [redacted]'s net profit margin would be acceptable?

3. Whether, in lieu of the advance payment and offsetting expenses methodology noted in questions 1 & 2 above, it would be appropriate to include in [redacted]'s income (prior to the sail date) that portion of the fee which the customer would have to forfeit to [redacted] should he/she cancel the cruise (cancellation fee), without any allowance for offsetting expenses?

4. Whether the fact that a small portion ([redacted]%) of the outstanding deposits at any particular time are for cruises which have a sail date more than 1 year in the future negates the application of Rev. Proc. 71-21, 1971-2 C.B. 549?

CONCLUSIONS

1. [redacted]'s expenses for airline tickets, cabin space, and travel agents' commissions are properly accruable when incurred.

2. These expenses should not be determined with reference to a net profit margin.

3. These expenses are accruable business expense deductions and need not be matched with customer advance payments. It is incorrect to accrue as income only the cancellation fee portion of advance payments.

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4. As a service provider, [redacted] may use Rev. Proc. 71-21, 1971-2 C.B. 549. The fact that some deposits may not meet the requirements for deferral under the Rev. Proc. does not negate its applicability in this case.

FACTS

We incorporate by reference the facts as set forth in your memoranda dated August 16, 1990, and October 28, 1991, as well as in our memorandum of May 24, 1991. In your request for advice, you included copies of the notice of proposed adjustment and the taxpayer's response to the case manager. From these documents, we note one change in the facts as originally provided to us. The contract with each customer requires full payment 45 days prior to departure, but a customer may cancel and receive a full refund up to 31 days prior to departure. If passengers cancel 30 days or less prior to departure, a cancellation fee or penalty would apply. That is, customers would receive a refund for less than the advance payment for cancellations made 30 days or less prior to their scheduled departure date.

DISCUSSION

1. Expense Deductions

[redacted] is a travel or booking agent and is properly characterized as a service provider, who sells vacation packages purchased from various vendors. [redacted]'s business expenses for airline tickets, cabin space, and travel agents' commissions are accruable when incurred, that is, when the requirements of sections 162 and 461 have been met. These expense deductions are accruable independently from the timing of accrued income for its customer payments. See issue 3, infra.

An accrual method taxpayer is entitled to deduct an expense in the year in which it is incurred, section 162(a), regardless of when it is actually paid. Treas. Reg. § 1.162-1(a) provides for the deductibility of ordinary and necessary business expenses, which includes the trip package components purchased by [redacted] as well as any travel agents' commissions.

For those expenses which are accruable prior to July 18, 1984, the standard for determining when an expense is to be regarded as incurred for federal income tax purposes is the all events test prescribed by Treas. Reg. § 1.461-1(a)(2). The two elements or prongs of the test are that all the events must have occurred which establish the fact of the liability and the amount can be determined with reasonable accuracy. Although expenses may be deductible before they become due and payable, liability must be firmly established.

In addition, the economic performance requirements of section 461(h) are effective on July 18, 1984, and apply to those expenses which were not deductible under pre-461(h) law until after July 18, 1984. See generally Prop. Treas. Reg. § 1.461-0 (Proposed Treas. Dec. IA-258-84, published 6-7-90). Prop. Treas. Reg. §1.461-4(d)(i) provides that if the liability of the taxpayer requires the taxpayer to provide services or property to another person, economic performance occurs as the taxpayer incurs costs (within the meaning of the accrual method as defined in Treas. Reg. § 1.446-11(c)(1)(ii)) in connection with the satisfaction of the liability. In applying these provisions, we believe that the all events test has been met and [redacted] has incurred costs within the meaning of Treas. Reg. § 1.446-1(c)(1)(ii) prior to its customers actually taking the trips. "The existence of an absolute liability is necessary; absolute certainty that it will be discharged by payment is not." United States v. Hughes Properties, 476 U.S. 593, 606 (1986). The contingent possibility of cancellations does not prevent the accrual of these expenses. In this case, cancellations occur infrequently, and we believe they are remote possibilities, not affecting accrual, as discussed in Hughes, 476 U.S. at 601-02. We do not have enough facts to determine exactly when all of [redacted]s expenses may be incurred. For example, we realize that in some instances [redacted] may purchase trip components in bulk and the timing for the expenses will depend upon the exact arrangements with the vendors. In any event, [redacted] need not defer accruing its business expenses until its customers have taken their trips.

Using an individual airline booking as an example, the possibility that the ticket would not be used and returned for refund does not preclude its accrual by [redacted] when the cost has been incurred. We believe that all events have occurred to determine the fact and amount of liability upon purchase by [redacted] regardless of when actual payment is made to the vendor or when the ticket is actually used by the customer. Potential nonpayment of an incurred liability does not prevent the accrual of the expense. Hughes Properties, supra.

2. Determining Expenses By Net Profit Margin

In light of our conclusion as to issue one, these expenses should not be determined with reference to a net profit margin.

3. Including Only Cancellation Fee in Income

We do not agree with accruing into income only the cancellation fee portion of the advance payments. As we stated in our May 24, 1991, memorandum, because of [redacted]'s deposit and refund policy, income deferral is appropriate until the customer is no longer entitled to a full refund. This legal position is based upon the rational of the Supreme Court in Commissioner v. Indianapolis Power & Light, 493 U.S. 203 (1990). In that case, customer payments were commingled with other funds and subject to taxpayer's unfettered use and control. 493 U.S. at 205. The customer, though, controlled the timing and method of refund and upon paying a deposit, made no commitment to purchase any amount of electricity. "In determining whether a taxpayer enjoys 'complete dominion' over a given sum, the crucial point is not whether his use of the funds is unconstrained during some interim period. The key is whether the taxpayer has some guarantee that he will be allowed to keep the money." 493 U.S. at 210. The Court stated that the customer made no commitment to purchase services, and taxpayer's right to retain the money was contingent upon events outside it control. Id. at 214. In contrast, the individual who makes an advance payment retains no right to insist upon the return of the funds; if the payee fulfills the terms of the bargain, it may keep the money. Id. at 212.

Therefore, in applying the law of Indianapolis Power to the facts of this case, we believe that [redacted] does not have the requisite guarantee of keeping the customer payments until the 30th day prior to trip departure. Its right to the funds prior to that time is contingent upon events outside its control.

Based on the facts as we now understand them, customers may cancel a trip and receive a full refund up to 31 days prior to departure. Our position is that the payments must be accrued into income on the 30th day prior to the trip departure at which time [redacted] gains dominion over the funds. Cancellations subsequent to the 31st day are eligible for only a partial refund. Once payments are no longer fully refundable, and thus no longer considered deposits, the full payment amount must be accrued into income. Although it is irrelevant to our legal position on this issue, we note that forfeited deposit amounts are minuscule.

Please note that in our earlier advice we stated that [redacted]'s services were provided upon the 45th day prior to departure at which time a customer's payment was due in full. We thought that customers received only partial refunds for cancellations after the 45th day, and we stated that the "proper time to view [redacted]'s services as completed is upon the 45th day prior to departure at which time payment is due in full." Although full payment is due upon the 45th day prior to departure, we now know that customers may receive full refunds up to the 31st day prior to departure. In addition, we now believe that the completion of [redacted]'s services should not be tied to when full payment is made. We believe that [redacted]'s services have been provided to its customers when the trip package reservations are made with the various vendors. At such time, [redacted] has most likely incurred some accruable business expenses also. Thus, by the 31st day prior to departure, we assume in most instances [redacted] has rendered all services to its customers. Even if all services have not been rendered, and payments may be considered "advance payments" for services, the law of Indianapolis Power does not allow deferral beyond the 31st day.

[redacted]'s business expenses for trip component costs need not be matched exactly with the related customer payments. The use of the term offset is incorrect. These expenses are accruable business expense deductions and need not be matched with customer payments. The matching principle of financial accounting (that related items of income and expense must be recorded in the same taxable year) is sometimes relevant in testing whether a particular accounting method clearly reflects income for tax purposes. The clear reflection standard, though, varies as the facts and circumstances of each case vary. One important aspect of the clear reflection standard is that all items of gross income and expense are treated consistently from year to year. Treas. Reg. §1.446-1(a)(2). Matching alone is never determinative of a clear reflection of income. Nor is matching the determinative test for finding a fixed liability or for permitting a deduction. Rather, expenses may be properly deductible in a year that is either prior or subsequent to the year in which income related to such expenses is includible. This is due to the fact that taxable income must be computed on an annual basis and computation of taxable income does not necessarily follow business accounting practices. See, e.g., Michael Drazen v. Commissioner, 34 T.C. 1070, 1077-78 (1960).

Lastly, we will comment on the taxpayer's discussion in its protest of the completed voyage or completed trip method of accounting. Under this method of accounting, both expenses and income related to a specific trip or voyage are deferred until the completion of the trip. Taxpayer argues that this method of accounting, as mentioned in PLR 8249018, has been used in the shipping industry with approval for many years and has never been challenged as not clearly reflecting income. In PLR 8249018 a cash basis taxpayer sought to defer reporting advance payments received on travel contracts until completion of the contract, and the ruling concluded that it could not. The ruling notes that taxpayer also submitted a Form 3115, seeking permission to change from the cash to the completed trip method of accounting.

Taxpayer cites numerous cases for the proposition that a completed voyage method of accounting clearly reflects income. e.g. Falketind Ship Co. v. Commissioner, 6 B.T.A. 44 (1927); Seas Shipping Co. v. Commissioner, 1 T.C. 30 (1942). Basically the cases cited equated the crop method of accounting with the completed trip method of accounting. For example, in Kahuku Plantation Co. v. Commissioner, 12 B.T.A. 977 (1928), the court stated that under the crop method of accounting receipts are not to be treated as income or payments treated as expenses until the sale or other disposition of the crop is substantially completed and its outcome is known. Citing Falketind the court states that the voyage method of accounting has been recognized by the Board of Tax Appeals as proper in the case of a round trip voyage, where receipts for passage and freight received in advance of the voyage are to be offset by the expenses of the voyage subsequently incurred. In Planet Line Inc. v. Commissioner, 34 B.T.A. 253 (1936), aff'd, 89 F.2d 16 (2d Cir. 1937), the completed voyage method was referred to as a variation of the accrual method of accounting, and in the court's opinion, it clearly reflected income.

Treas. Reg. §1.446-1(c)(1)(iii) discusses special methods of accounting and refers as an example to sections 61 and 162, and the crop method of accounting. Treas. Reg. §1.162-12(a) discusses the expenses of farmers and provides that after July 12, 1972, where a farmer is engaged in producing crops and the process of gathering and disposal of such crops is not completed within the taxable year in which such crops were planted, expenses deducted may, with the consent of the Commissioner (sections 446 and the regulations thereunder), be determined upon the crop method, and such deductions must be taken in the taxable year in which the gross income from the crop has been realized. Treas. Reg. §1.446-1(e)(2)(ii)(a) discusses obtaining the Commissioner's consent for changes in methods of accounting and provides that changes in methods of accounting include ..."a change involving the adoption, use or discontinuance of any other specialized method of computing taxable income, such as the crop method...." This is consistent with PLR 8249018, cited by the taxpayer, in which a taxpayer had submitted a Form 3115 seeking permission to change to the completed trip method of accounting, which pursuant to case law is treated as equivalent to the crop method of accounting. The important point with respect to [redacted] is that regulations establish that the crop method of accounting (and a fortiori, the equivalent completed trip method of accounting) is a special method, and after July 12, 1972, requires the specific consent of the Commissioner. We assume that [redacted] does not have the Commissioner's consent to use this method of accounting. Furthermore, we also assume that because [redacted] is not a shipper, it would not qualify to use this accounting method.

4. Application of Rev. Proc. 71-21

Rev. Proc. 71-21, 1971-2 C.B. 549, provides procedures for accrual basis taxpayers to defer inclusion in income of payments received or amounts due in one taxable year for services to be performed in the next year. Under the facts of this case, Rev. Proc. 71-21 will sometimes be applicable because deposits (and sometimes full payments) will be received prior to [redacted]'s completion of its services of arranging a trip package. As discussed, our position is that [redacted] must accrue customer payments into income upon the 30th day prior to departure, when customers are no longer entitled to a full refund.

As a service provider, [redacted] may use Rev. Proc. 71-21. Because of the facts of this case and our position regarding when [redacted]'s services have been provided and when the customers' payments must be accrued into income, the application of Rev. Proc. 71-21 will result in the deferral of income in so few circumstances that its application to this taxpayer is virtually negligible. The fact that a few deposits may not meet the requirements of Rev. Proc. 71-21 does not negate its application to all deposits.

Indianapolis Power provides that advance payments are taxable income where the payee has a guarantee that it may keep the money if it performs its contractual obligations. Prior to the 30th day, we believe customers have made contingent payments and not unequivocally made purchase commitments. The payments are not subject to [redacted]'s complete dominion nor is there a guarantee that the funds may be kept. See Commissioner v. Indianapolis Power & Light, 493 U.S. 203(1990). We believe that on the 30th day the payment converts from a refundable deposit holding spaces for the customer to payment for the services of [redacted] in arranging the travel package. Therefore, prior to the 30th day, we believe that the payments need not be accrued because there is no guarantee that [redacted] can keep the money. Indianapolis Power. Thus, Rev. Proc. 71-21 provides an alternative theory to allow a deferral of either deposits or full payments where such payments occur in one taxable year and [redacted]'s trip arrangement services occur in the next taxable year.

As we stated in our earlier advice, Rev. Proc. 71-21 would also allow income deferral in two other circumstances involving other taxpayers. Although [redacted]'s services are completed prior to the actual travel dates, this is not true for the transportation component vendors and [redacted]. The vendors may be eligible to defer accruing income received from [redacted] because their services are to be provided in the future. Also, [redacted] should be able to defer income under Rev. Proc. 71-21 for its cabin bookings sold directly to passengers for trips which won't take place until the next taxable year.

As a final point, we are aware that the examining agents have questioned whether the fact that [redacted] does not escrow the funds received from its customers has any relevance for the timing of the income accrual. In Indianapolis Power, the Court emphasized that the company had an obligation to repay the customer deposits either upon termination of service or when a customer had established good credit. The Court found that the taxpayer lacked the requisite complete dominion over the deposited funds and held that the failure to escrow or physically segregate the deposits from general funds was not dispositive in determining whether the company enjoyed complete dominion over the funds. Rather, the Court stated that the key is whether the taxpayer has some guarantee that it will be allowed to keep the money, and the taxpayer did not have such a guarantee. We have applied the Indianapolis Power rationale to the timing of the income accrual in this case, and we believe that the lack of an escrow account in this case is also not dispositive on the issue of whether [redacted] enjoyed complete dominion over customer payments until 30 days prior to trip departure. Its responsibility to make full refunds to customers upon request was unequivocal, and the lack of an escrow account is irrelevant to the determination that it lacked complete dominion over the funds.

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If you have any further questions concerning this matter, please contact Joyce C. Albro at FTS 566-3442.

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